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SECOND MONETARY POLICY REPORT FOR 1983

FROM THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

A REPORT

together with

ADDITIONAL AND MINORITY VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW 95-523

SEPTEMBER 15 (legislative day, SEPTEMBER 12), 1983.—Ordered to be printed.

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LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C., ---------- *1983.*

Hon. GEORGE BUSH,
President of the U.S. Senate,
Washington, D.C.

DEAR MR. PRESIDENT: Transmitted herewith is the Second Monetary Policy Report for 1983 on the Conduct of Monetary Policy, pursuant to Public Law 95–523 and oversight hearings held on July 21, 1983.

Sincerely yours,

JAKE GARN, *Chairman.*

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SEPTEMBER 15 (legislative day, SEPTEMBER 12), 1983.—Ordered to be printed.

Mr. GARN, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

ADDITIONAL VIEWS

On July 21, 1983, the Committee on Banking, Housing, and Urban Affairs received this year's second "Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978" (Public Law 95–523) from the Board of Governors of the Federal Reserve System.

A hearing on the report and on the conduct of monetary policy also was held on July 21, 1983. Witnesses were: Federal Reserve Board Chairman Paul A. Volcker; Martin Feldstein, Chairman, the President's Council of Economic Advisers; Beryl Sprinkel, Department of the Treasury, Under Secretary for Monetary Affairs; Alan Blinder, professor of economics, Princeton University; and A. James Meigs, senior vice president and chief economist, First Interstate Bank of California.

MONETARY GROWTH

The acceleration in the growth rate of the M–1 monetary aggregate which began in the latter half of 1982 continued through the first half of 1983. From the fourth quarter of last year through June, M–1 grew at an average annual rate of 14 percent. This compares with the target range of 4 to 8 percent for growth in M–1 announced by the Federal Reserve in February.

For M–2, the Federal Reserve announced a 1983 realized growth rate of 9.1 percent which was only slightly above the midpoint of the aggregate's target range, but as outlined in the "First Monetary Policy Report for 1983," the base for this growth was shifted upward significantly at the beginning of the year. Professor Blinder pointed out to the committee that, ignoring the upward shift in M–2's base, the aggregate has been growing at a 16-percent annual rate.

M–3 grew at the upper boundary of its target range, and total domestic nonfinancial sector debt grew at a rate comfortably within the range estimated for it.

VELOCITY

Professor Blinder told the committee that rapid growth in the aggregates was appropriate to offset continued declines in velocity:

> As long as velocity is declining, seemingly high monetary growth rates are not only appropriate, but are actually essential if recession is to be avoided.

Chairman Volcker explained the decline in M–1 velocity in terms of several factors that increased the demand for the assets included in the aggregate:

> The unusually large and sustained drop in M–1 velocity may * * * in large part reflect an enhanced demand for M–1 that arose from the decline in inflation and the related sharp fall in market interest rates during the second half of 1982. The availability of interest-bearing NOW accounts may have made depositors even more willing to hold funds in M–1-type accounts as market interest rates declined. In addition, M–1 was probably boosted by heightened savings and precautionary demands.

Secretary Sprinkel argued, though, that increased use of M–1 as a repository for savings cannot explain all of the recent acceleration in the aggregate's growth rate:

> Even after adjusting recent money growth rates for the growth of deposits now included in M–1 that may have attributes of savings, money growth remains high by any historical standard.

Mr. Volcker also pointed to institutional change as the source of decline in M–2 velocity:

> * * * the enthusiastic reception of the public to—and aggressive marketing by depository institutions of—the new ceiling-free money market deposit accounts plainly affected growth in M–2.

Secretary Sprinkel warned, however, that the perceived decline in velocity may not reflect a true change in the demand for money but instead may be a misleading temporary mathematical result of the delayed impact of money growth on nominal GNP:

> * * * a substantial proportion of the recent decline in velocity can be directly attributed to the acceleration of money growth itself. An acceleration of money growth in one quarter cannot be expected to induce higher nominal GNP growth in the same quarter; it takes two or three quarters for an increase in money growth to stimulate spending and induce an associated increase in nominal GNP growth. Since a large increase in the rate of money growth causes no immediate increase in nominal GNP, and velocity growth is simply the ratio of nominal GNP growth to money growth, the immediate effect of accelerated money growth is likely to be a contemporaneous

> decline in velocity. Ultimately, the accelerated money growth stimulates nominal GNP growth and velocity rebounds. But if money growth continues at a rapid pace, as it has over the last 10 months, velocity could continue to be suppressed until nominal GNP growth "catches up" to the increased money growth.

If this is the correct explanation of the declines in measured velocity, the result of the continued above-target growth in M–1 could be renewed inflationary pressures.

Chairman Volcker, too, cautioned the committee that at least some of the recent declines in velocity might prove temporary:

> * * * there are signs that the period of velocity decline may be ending. In looking ahead, with the economy expanding and with ample time for individuals and others to have adjusted to the rapid decline in interest rates last year, we must be alert to the possibility of a rebound in velocity along usual cyclical patterns, even though the longer term trend may be changing.

In response to the apparent end to declines in velocity, Mr. Volcker told the committee that the Federal Reserve already had taken steps to slow down growth:

> * * * the Federal Open Market Committee, beginning in late May, has taken a slightly less accommodative posture toward the provision of bank reserves through open market operations, leading to some increase in borrowings at the discount window. Whether viewed from a domestic or international perspective, limited, timely and potentially reversible measures now, when the economy is expanding strongly, are clearly preferable to the risks of permitting a situation to develop that would require much more abrupt and forceful action later to deal with new inflationary pressures and a long-sustained pattern of excessive monetary and credit growth.

INFLATION, GNP, AND INTEREST RATES

Dr. Meigs told the committee that:

> Bringing inflation down from a peak 12-month rate of nearly 15 percent in early 1980 to 3.5 percent in May of this year was a stunning achievement.

Chairman Volcker told the committee that:

> Finished producer prices were generally unchanged over the first half of 1983 * * *. Perhaps more significant for the future, the rate of nominal wage increase—at about 4-percent annual rate—is now at its lowest level since the mid-1960's, while average real wages, as in 1982, are rising. That pattern has been assisted by sizable productivity gains.

Chairman Volcker also told the committee that:

> Over the past 6 or 7 months of expansion, output has risen about as fast as in the average postwar recovery, more than 1 million more people are employed, and the unemployment rate has dropped by nearly a percentage point * * *.

In light of the impressive 8.7 percent annual rate of real growth in GNP (gross national product) during the second quarter of this year, Chairman Feldstein told the committee that the administration now projects a real growth rate of 5.5 percent from the final quarter of last year to the final quarter of 1983.

Dr. Meigs attributed the sharp upsurge in economic growth to the lagged impact of accelerated money growth and warned that other consequences—ones with somewhat greater lags in their appearances—could be rising interest rates and renewed inflationary pressures:

> The sharp acceleration in growth of the money supply over the past year is the main reason the economic recovery is suddenly exceeding practically all of the governmental and private forecasts that were published during 1982. The boost to economic activity and employment is welcome, but it may prove to be a costly one. Enough monetary stimulus has already been injected to raise inflation two or more percentage points by the end of 1984, I believe. If monetary expansion were to continue for another year at the rate of the past year, inflation would rise to more than a 10-percent annual rate by the end of 1985.
>
> Well before such a rise in inflation reached its peak, both long-term and short-term interest rates would rise by comparable amounts, because world financial markets are now extremely sensitive to signs of future inflation."

Secretary Sprinkel agreed:

> The accumulating evidence of a stronger-than-expected recovery is a predictable result of a highly stimulative monetary policy; historically a sustained acceleration of money growth causes an expansion in economic activity 6 to 9 months later. Economic stimulus is, however, only the immediate, temporary effect of accelerated money growth; if excessive money growth is maintained, the permanent effects are rising inflation and interest rates which are pervasive deterrents to real economic growth.

Dr. Feldstein, however, argued that financial markets are not yet anticipating renewed inflation because those markets expect the Federal Reserve to act to slow M–1 growth:

> The anticipation that the Federal Reserve will pursue an appropriate policy to slow M–1 growth explains why, despite the rapid growth of M–1, the financial markets do not appear to be concerned about a near-term rise in inflation. The price of inflation hedges like gold has not risen as it would if a new inflationary surge were feared. Similarly, the rise in the exchange value of the dollar shows confidence that the purchasing power of the dollar will not be eroded and a belief that the rise in interest rates represents a rise in real rates and not compensation for faster anticipated inflation.

Secretary Sprinkel reminded the committee that the administration has "consistently emphasized the need to reduce inflation and interest rates as a prerequisite to sustainable real economic growth * * *." In

this regard, he pointed out that the "prime rate * * * is now 600 basis points below where it was a year ago and 1,100 basis points below its December 1980 level," but that "* * * market rates have ceased their decline and have begun to rise again since early May." The Secretary also cautioned the committee that:

> * * * the facts clearly contradict the widespread and much-publicized view that interest rates fell last year "after the Fed eased up on money growth." By the time the acceleration of money growth became evident last fall, the decline in short rates had already occurred. Furthermore, the rapid money growth of the last 9 to 10 months has not provided for any further declines in rates.

FEDERAL BUDGET DEFICITS

Chairman Volcker once again stressed the problems posed for monetary policy and the economic expansion by the prospect of continuing enormous Federal budget deficits:

> * * * deficits appear likely to remain close to $200 billion for several years, even taking account of economic growth at the higher rates now projected * * *. That outlook raises a fundamental question about the consistency of the budget outlook with the kind of economy we want. That is particularly the case with respect to such heavy users of credit as housing and business investment. To put the issue pointedly, the Government will be financed, but others will be squeezed out in the process * * *. All of this, to my mind, points up the urgency of further action to reduce the budgetary deficit to make room for the credit needed to support growth in the private economy. Left unattended, the situation remains the most important single hazard to the sustained and balanced recovery we want.

Chairman Feldstein drew a direct link between these deficits and high inflation-adjusted or real interest rates:

> The fundamental reason for the high level of real interest rates is the widespread expectation of large budget deficits for the remainder of the decade * * *. Budget deficits of $150 billion to $200 billion would absorb funds equal to between half and two-thirds of the net private saving of households, businesses, and State and local governments. To reduce the borrowing demand of private investors and households to the remaining small amount of funds would inevitably require high real interest rates.

Dr. Feldstein identified these deficit-caused high interest rates as the major cause of the international trade problems now confronting the U.S. economy:

> The high and rising real interest rate on long-term bonds has caused the dollar to rise about 40 percent since 1980 relative to the other major currencies after adjusting to differences in inflation. Just since January of this year, the dollar

> has risen an average of nearly 8 percent relative to other major currencies. The strong dollar has caused a decline in exports and a rise in imports that is likely to result in a record merchandise trade deficit this year of more than $60 billion. By next year there is a substantial risk that the trade deficit will be more than $100 billion. Many key American industries are hit particularly hard by this fall in the competitiveness of U.S. exports and the increased attractiveness of imports.

Secretary Sprinkel told the committee that these deficit-related interest rates also threaten future job creation in the U.S. economy:

> Domestically, the level of interest rates will be an important determinant of the mix of output growth as the economy expands; lower interest rates would encourage the capital investment that is needed to expand job opportunities, improve productivity, and enhance the ability of U.S. industry to compete abroad.

FUTURE TARGETS

Chairman Volcker announced that the FOMC had voted to maintain the February targets and estimated growth ranges during the remainder of 1983 for M–2, M–3, and total domestic nonfinancial sector debt. These call for growth in M–2 within a range of 7 to 10 percent, for growth in M–3 within a range of 6½ to 9½ percent, and for growth in total domestic nonfinancial sector debt within a range from 8½ to 11½ percent.

On the other hand, Mr. Volcker announced that the FOMC had decided not to seek to slow M–1 growth to the extent that would be necessary to bring the aggregate's growth back within the target range announced in February. Rather, Mr. Volcker announced that second-quarter 1983 M–1 would be used as the base for targeted future growth in the aggregate and that, for the remainder of 1983, the Federal Reserve would seek growth in M–1 within a range of 5 to 9 percent.

Chairman Feldstein told the committee that, "* * * the appropriate goal of (monetary) policy at this time should be to slow M–1 without reducing the growth rate of M–2," and he also expressed his opinion that the Federal Reserve's new target range for M–1 growth is "appropriate."

Professor Blinder rejected the whole procedure of basing monetary policy on targets for growth in the aggregates because, he argued, our inability to forecast future changes in velocity makes it impossible to set appropriate targets for money growth.

Instead of relying primarily on targets for growth in the aggregates, Professor Blinder argued for primary reliance on interest rate targets:

> Interest rates always carry a clue about what velocity is doing. If the Fed sets a monetary target and then finds that interest rates rise unexpectedly, the evidence is pointing to falling velocity. The monetary growth target probably should be adjusted upward to compensate. Conversely, if the Fed finds interest rates falling unexpectedly, then velocity is probably rising and the monetary growth target should be adjusted downward.

Secretary Sprinkel, however, argued against interest rate targeting:

> Interest rates are superficially an appealing variable for monetary policy—in the sense that they are visible and easily understood by the public. The Federal Reserve cannot, however, control interest rates with an acceptable level of precision over the long run. Even if the Federal Reserve were able to control interest rates with reasonable precision, the relationship between interest rates and nominal GNP growth is not well understood or reliable. Without a dependable relation between the level or rate of change in interest rates and economic activity, interest rates do not provide the Fed with reliable information on when to change interest rates (if they could), or by how much, to have the desired effect on the economy. Furthermore, in the past, attempts to control interest rates have resulted in an inflationary bias in monetary policy.

CONCLUSIONS

Pursuant to the requirement in the Full Employment Balanced Growth Act for a report to the Senate by the Committee on Banking, Housing, and Urban Affairs stating its "views and recommendations" regarding the Federal Reserve's Monetary Policy Report, the committee finds:

1. The U.S. economy currently is enjoying a vigorous economic expansion with healthy growth in employment, real wages, and productivity. Inflation indexes are not, as yet, evidencing a return to upward pressures on prices.

While the prime rate has declined 1,100 basis points since December 1980 and other interest rates also are down considerably, serious concern is justified over recent interest rate upticks, for the administration is correct in its emphasis on "the need to reduce inflation and interest rates as a prerequisite to sustainable real economic growth."

2. While there is political appeal in calling on the Federal Reserve to target inflation-adjusted interest rates, it would be a serious mistake and counterproductive for the Federal Reserve to attempt to force rates down to some target levels with faster money growth.

In July interest rates moved upward as rapid money growth continued. Gradual slowing in the monetary aggregates' growth rates is the key to sustained declines in interest rates as well as to low inflation rates.

Rather than calling on the Federal Reserve to target real interest rates, with the acceleration in the economy and in private credit demands, the Congress should coordinate fiscal policy with monetary policy by reducing the size of the prospective Federal budget deficits. This would be a major contribution to efforts to lower interest rates.

3. It is dangerous for the Federal Reserve to seek to offset suspected changes in monetary velocity by allowing the monetary aggregates to diverge from their targeted growth paths. The danger that such a policy will lead to excessive money growth is particularly great if, as outlined by Secretary Sprinkel, accelerated money growth itself is a source of a perceived decline in velocity.

4. The rate of M–1 growth during the remainder of 1983, however, should not now be slowed to the extent necessary to bring the aggregate's growth for the year within the targets established last February; the sharp reduction in M–1 growth which would be required would pose too great a threat to the emerging economic expansion.

For this reason, the committee endorses the Federal Reserve's decision to use the second-quarter 1983 size of M–1 as the base for future growth within the range of 5 to 9 percent. The committee feels, however, that it is highly important for the Federal Reserve to keep M–1 growth as well as growth in the other aggregates within their target ranges during the remainder of 1983.

ADDITIONAL VIEWS OF MR. PROXMIRE

While I agree with the Report's findings that "the United States economy currently is enjoying a vigorous economic expansion with healthy growth in employment, real wages and productivity," I do not believe that expansion will be long-lived because our current and projected massive budget deficits will drive up interest rates and choke off the recovery. The Report touches upon this issue by noting that "Congress should coordinate fiscal policy with monetary policy by reducing the size of the prospective federal deficits." This point deserves further elaboration since the fiscal problem is the key to what will happen to our economy in the next few years.

When Paul Volcker became the Chairman of the Federal Reserve Board in 1979, he saw it was absolutely necessary to get inflation under control. That problem if not checked, would have resulted in both inflation and unemployment and terrible long-term damage to our society. To reverse that trend, the Federal Reserve tightened the money supply and slowed down the economy. As a result, the nation suffered greatly. Unemployment reached the highest levels in 40 years. We would not have gone through this purgatory if we had followed sensible fiscal policies and balanced the budget. Our spendthrift fiscal policy necessitated an excruciatingly painful monetary policy. Over time, inflation did slow and we are now at a point where we could achieve noninflationary economic growth—if only we could bring our fiscal policy back to sanity.

Since 1980, between the Congress and the Administration, we have sharply increased spending, reduced federal revenues in relationship to our needs and have created, not just a single year's deficit, but rather the assurance that we will have a series of massive near $200 billion plus annual deficits that will explode the national debt to more than two trillion dollars over the next four years or so. The government will be borrowing nearly 75 percent of all the country's net savings. When the government is borrowing 75 percent of all the money, there is less credit available for mortgage loans or auto loans and what credit is available becomes more expensive. This fact will be reflected in the price of credit and that price, of course, is the interest rate. So government deficits soaking up three-fourths of the nation's credit will drive interest rates higher and that will spell another slide into either high unemployment or runaway inflation. In time, the latter would also result in massive unemployment.

The day of reckoning is close at hand. It is coming with a vengeance. Interest rates have already begun to creep up and with massive federal borrowing they cannot do anything else but creep up—unless we get a torrent of money from the Federal Reserve. If the latter happens, inflation will pick up and interest rates will rise as well. Either way the recovery will be choked off by higher interest rates. All of this is not inevitable if only we could find the will to cut spending and raise

revenues so that we could balance the budget. Some will argue that any reduction in the deficit will retard the recovery because we will cut spending. The argument would have appeal if our deficit were in the $50 billion range. But our colossal $200 billion deficit is so excessive that even a hundred billion dollar diminution would leave plenty of stimulus for business while assuring the country that Congress is bringing the deficit under control. The Congress in its Budget Resolution recognized the need to get our fiscal house in order and asked the House and Senate Banking Committees to report on monetary policy in relation to the budget by September 30th. One of the assumptions behind that request was that any reduction in the budget deficit would reduce pressure on interest rates which in turn could bring in more revenues through a revised economy. Chairman Volcker told us recently that a $50 billion reduction in the projected $200 billion deficit would reduce interest rates by 1 percent or even more if it were taken as a first step in getting the deficits pared down.

We are nearing a national crisis on the deficit. Congress can take action now and avert the crisis.

WILLIAM PROXMIRE.

ADDITIONAL MINORITY VIEWS OF MESSRS. CRANSTON, RIEGLE, SARBANES, AND SASSER

We oppose the call for tighter money and higher interest rates contained in this Report.

The Committee presents a glowing report on current economic performance and a confident forecast for the immediate future, tempered only by a concern that recent monetary expansion may have been too rapid. This reflects an unstated fear that the recovery itself has been too rapid, and that it should be slowed down. We disagree.

Current conditions clearly warrant continued emphasis on rapid economic growth. There is no plausible argument for slower growth, higher interest rates, more unemployment and less production and investment today, in the doubtful hope of reducing inflationary risks four or five years from now.

The Committee states that the current economic expansion is "vigorous", with "healthy growth" in employment, real wages, and productivity. In fact, the current expansion is modest. The first two quarters of this recovery rank last in strength, when compared to the first two quarters of the eight cyclical expansions since 1949. Given the high levels of unemployment and idle capacity and relatively low inflation with which this recovery begins, a more rapid rate of growth could be sustained without unacceptable inflationary consequences. The Administration's own forecasts do not expect unemployment to fall to levels experienced as recently as 1980 until 1988—and then only if the expansion continues without interruption until then, which would make it the longest peacetime expansion in postwar history.

In recent months, the Federal Reserve has followed an appropriate policy. Faced with the clear incompatibility of its previous strict monetarism with economic growth, the Federal Reserve abandoned monetarism and has, since July 1982, kept its eye on the big picture—real economic growth, employment, and inflation. Easier monetary policy, combined with the jobs program enacted last winter produced lower interest rates and recovery. As it happened, the measured monetary aggregates grew rapidly. The Federal Reserve acted correctly in accepting this rapid expansion of the measured monetary aggregates.

The Committee urges the Federal Reserve to tighten money in the second half of 1983, though not too much. We view this suggestion as presumptuous. Recent changes in financial regulation and money market innovations have sharply altered the savings and portfolio behavior of the public. This has generated extreme uncertainty about the economic meaning of the measured monetary aggregates. In view of this uncertainty, continued flexibility in interpreting any monetary target, not a rigid commitment to that target, is what is required.

Tighter money now, brought about by a too-rigid interpretation of the monetary targets, would mean higher interest rates, slower re-

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covery and more unemployment, despite the Committee's attempt to state otherwise. The only question is whether current economic growth is too rapid. The Committee cites no evidence that it is. Therefore, in our view, there is no reason to slow the expansion at this time.

In our view, the Federal Reserve acted correctly in incorporating the past above-target growth of M–1 into the base for the remainder of 1983. Nor is the Federal Reserve's choice of a money growth path in the period immediately ahead—5 to 9 percent for M–1—necessarily inconsistent with the economic growth path we seek. But the Federal Reserve should continue to keep its eye on the big picture. If it turns out that continued strong recovery requires continued strong monetary growth, then for the immediate future the Federal Reserve should continue to place a low priority on meeting its M–1 target. A statement of intent to this effect would have a strong calming effect on the financial markets.

We note that the Open Market Committee's new practice, begun last February, of providing its economic forecasts to Congress, is continued in the Report before us, and that these forecasts are given prominence in the presentation of the Report, which they deserve. This reform greatly eases the task of monetary policy oversight and improves the climate of dialogue between Congress and its agent, the Federal Reserve.

ALAN CRANSTON.
DON RIEGLE.
PAUL SARBANES.
JIM SASSER.

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